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March 2008

Online at <http://mpra.ub.uni-muenchen.de/11864/>
MPRA Paper No. 11864, posted 02. December 2008 / 07:10

Eight Hundred Years of Financial Folly

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“History is indeed little more than the register of the crimes, follies, and misfortunes of mankind.”

Gibbon--Decline and Fall of the Roman Empire

The economics profession has an unfortunate tendency to view recent experience in the narrow window provided by standard datasets. With a few notable exceptions, cross-country empirical studies on financial crises typically begin in 1980 and are limited in other important respects.¹ Yet an event that is rare in a three decade span may not be all that rare when placed in a broader context.

In my paper with Kenneth Rogoff we introduce a comprehensive new historical database for studying debt and banking crises, inflation, currency crashes and debasements.² The data covers sixty-six countries in across all regions. The range of variables encompasses external and domestic debt, trade, GNP, inflation, exchange rates, interest rates, and commodity prices. The coverage spans eight centuries, going back to the date of independence or well into the colonial period for some countries.

In what follows, I sketch some of the highlights of the dataset, with special reference to the current conjuncture. We note that policymakers should not be overly cheered by the absence of major external defaults from 2003 to 2007, after the wave of

¹ Among many important previous studies include work by Bordo, Eichengreen, Lindert, Morton and Taylor.

² “This Time its Different: A Panoramic View of Eight Centuries of Financial Crises” National Bureau of Economic Research Working Paper 13882, March 2008a.

defaults in the preceding two decades. Serial default remains the norm; major default episodes are typically spaced some years (or decades) apart, creating an illusion that “this time is different” among policymakers and investors. We also find that high inflation, currency crashes, and debasements often go hand-in-hand with default. Last, but not least, we find that historically, significant waves of increased capital mobility are often followed by a string of domestic banking crises.

The Big Picture

What are some basic insights one gains from this panoramic view of the history of financial crises? We begin by discussing sovereign default on external debt.

Default cycles

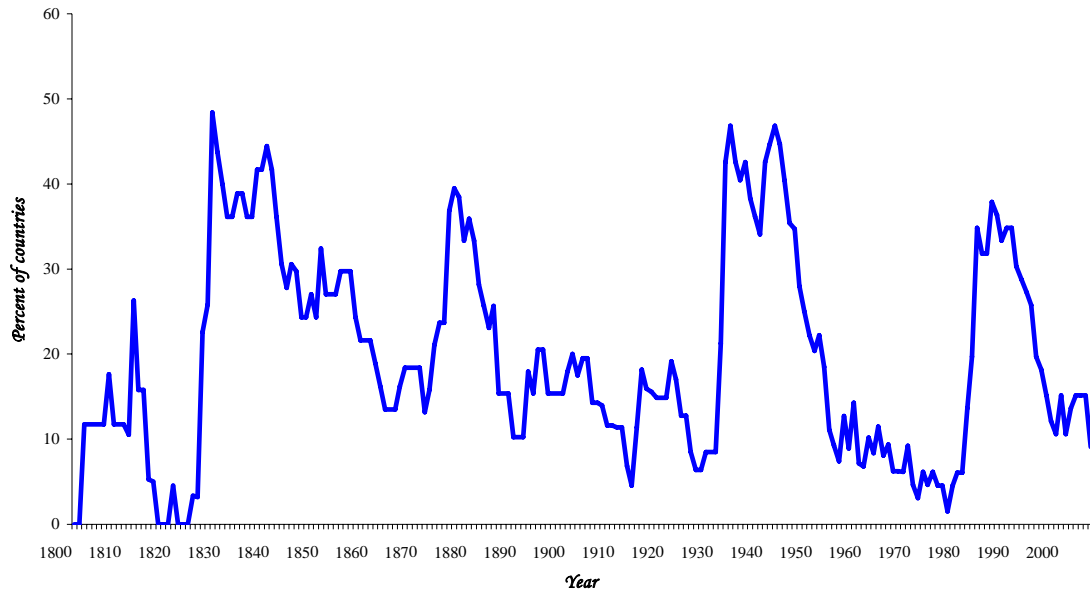
For the world as a whole (or at least the more than 90 percent of global GDP represented by our dataset), the current period can be seen as a typical lull that follows large global financial crises. Figure 1 plots for the years 1800 to 2006 the percentage of all independent countries in a state of default or restructuring during any given year.

Aside from the current lull, *one fact that jumps out from the figure are the long periods where a high percentage of all countries are in a state of default or restructuring.*

Indeed, there are five pronounced peaks or default cycles in the figure. The first is during the Napoleonic War while the most recent cycle encompasses the emerging market debt crises of the 1980s and 1990s.

Figure 1

Sovereign External Debt: 1800-2006
Percent of Countries in Default or Restructuring



Source: Reinhart and Rogoff (2008a).

Serial default on external debt—that is, repeated sovereign default—is the norm throughout nearly every region in the world, including Asia and Europe.

Our dataset also confirms the prevailing view among economists that *global economic factors, including commodity prices and center country interest rates, play a major role in precipitating sovereign debt crises.*

During the past few years emerging markets have benefited from low international interest rates, buoyant world commodity prices and solid growth in the United States and elsewhere.³ If things can't get better—the odds are that they will get worse. US interest rates are likely to remain low, this helps debtor countries enormously.

³ See Jeffrey Frankel, “An Explanation for Soaring Commodity Prices”, March 2008, <http://www.voxeu.org/index.php?q=node/1002>

Weaker growth in the US and other advanced economies soften growth prospects for export-dependent emerging Asia and elsewhere; inflation is on the rise. Is this cycle different?

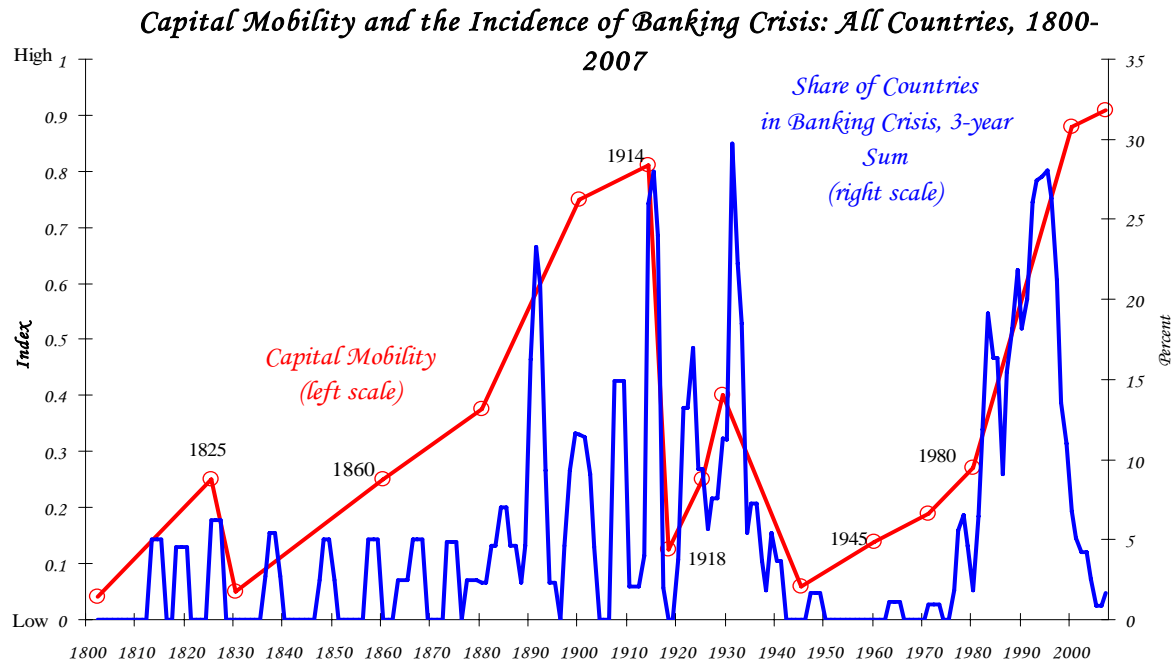
Financial liberalization, capital inflows and financial crises

Another regularity found in the literature on modern financial crises is that countries experiencing large capital inflows are at high risk of having a debt crisis. Default is likely to be accompanied by a currency crash and a spurt of inflation. The evidence here suggests the same to be true over a much broader sweep of history, with surges in capital inflows often preceding external debt crises at the country, regional, and global level since 1800, if not before.

Also consonant with the modern theory of crises is the striking correlation between freer capital mobility and the incidence of banking crises, as shown in Figure 2. *Periods of high international capital mobility have repeatedly produced international banking crises, not only famously as they did in the 1990s, but historically.* The figure plots a three-year moving average of the share of all countries experiencing banking crises on the right scale. On the left scale, we employ our favored index of capital mobility, due to Obstfeld and Taylor (2004),⁴ updated and backcast using their same design principle, to cover our full sample period; while the index may have its limitations, it nevertheless provides a summary of de facto capital mobility based on actual flows.

⁴ Obstfeld, Maurice, and Alan M. Taylor, *Global Capital Markets: Integration, Crisis, and Growth*, Japan-U.S. Center Sanwa Monographs on International Financial Markets (Cambridge: Cambridge University Press, 2004).

Figure 2



Sources: Reinhart and Rogoff (2008a), Obstfeld and Taylor (2004), and these authors.

Domestic debt and the “this time it’s different syndrome”

As noted, our database includes long time series on domestic public debt.⁵

Because historical data on domestic debt is so difficult to come by, it has been ignored in the empirical studies on debt and inflation. Indeed, many generally knowledgeable observers have argued that the recent shift by many emerging market governments from external to domestic bond issues is revolutionary and unprecedented.⁶ Nothing could be further from the truth, with implications for today’s markets and for historical analyses of debt and inflation.

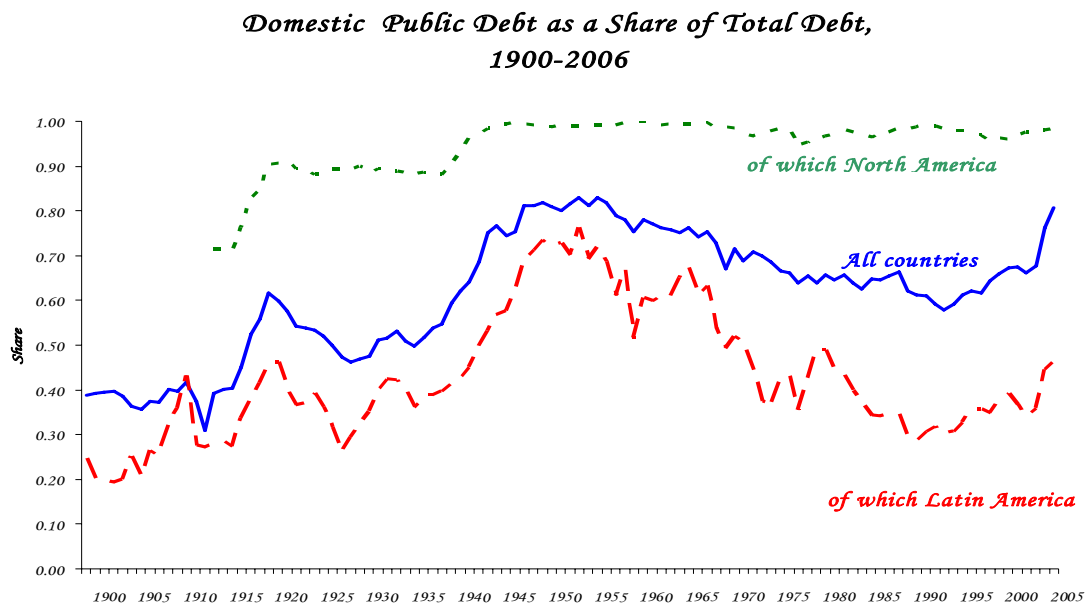
⁵ For most countries, over most of the time period considered, domestically issued debt was in local currency and held principally by local residents. External debt, on the other hand, was typically in foreign currency, and held by foreign residents.

⁶ See the IMF Global Financial Stability Report, April 2007; many private investment-bank reports also trumpet the rise of domestic debt as a harbinger of stability.

The topic of domestic debt is so important, and the implications for existing empirical studies on inflation and external default are so profound, that we have broken out our data analysis into an independent companion piece.⁷ Here, we focus on a few major points. *The first is that contrary to much contemporary opinion, domestic debt constituted an important part of government debt in most countries, including emerging markets, over most of their existence.* Figure 3 plots domestic debt as a share of total public debt over 1900 to 2006. For our entire sample, domestically issued debt averages more than 50 percent of total debt for most of the period. Even for Latin America, the domestic debt share is typically over 30 percent and has been at times over 50 percent.

Furthermore, contrary to the received wisdom, these data reveal that a very important share of domestic debt—even in emerging markets— was long-term maturity.

Figure 3



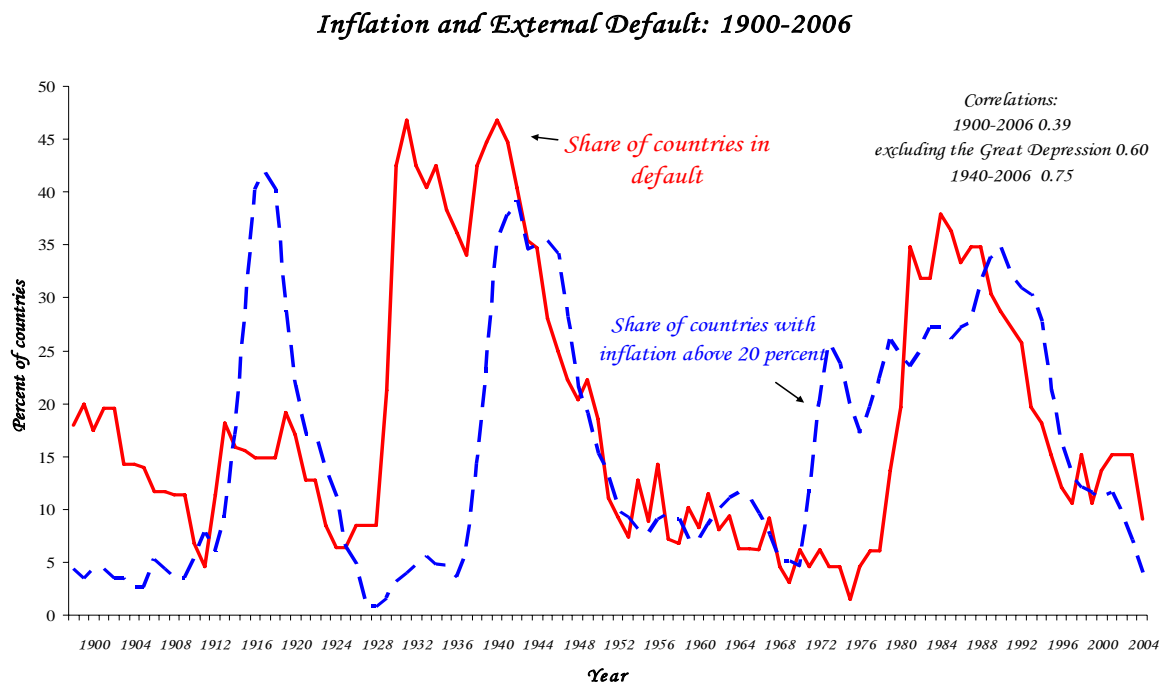
⁷ Carmen M. Reinhart and Kenneth S. Rogoff Domestic Debt: The Forgotten History,” NBER Working Paper 13946, April 2008b.

The inflation-default cycles

Figure 4 on inflation and external default (1900 to 2006) illustrates the striking correlation between the share of countries in default on debt at one point and the number of countries experiencing high inflation (which we define to be inflation over 20 percent per annum). Thus, there is a tight correlation between the expropriation of residents and foreigners.

As noted, investment banks and official bodies, such as the International Monetary Fund, alike have argued that even though total public debt remains quite high today in many emerging markets, the risk of default on external debt has dropped dramatically because the share of external debt has fallen.

Figure 4



This conclusion seems to be built on the faulty premise that countries will treat domestic debt as junior, bullying domestics into accepting lower repayments or simply defaulting

via inflation. *The historical record, however, suggests that a high ratio of domestic to external debt in overall public debt is cold comfort to external debt holders. Default probabilities depend much more on the overall level of debt.*

Policy Issues

This brings us to our central theme—the “this time is different syndrome.” There is a view today that both countries and creditors have learned from their mistakes. Thanks to better-informed macroeconomic policies and more discriminating lending practices, it is argued, the world is not likely to again see a major wave of defaults. Indeed, an often-cited reason these days why “this time it’s different” for the emerging markets is that governments are managing the public finances better, albeit often thanks to a benign global economic environment and extremely favorable terms of trade shocks.

Such celebration may be premature. Capital flow/default cycles have been around since at least 1800—if not before. Technology has changed, the height of humans has changed, and fashions have changed. Yet the ability of governments and investors to delude themselves, giving rise to periodic bouts of euphoria that usually end in tears, seems to have remained a constant.

On a more positive note, our research at least raises the question of how a country might “graduate” from a history of serial default. Interesting cases include Greece and Spain, countries that appear to have escaped a severe history of serial default not only by reforming institutions, but by benefiting from the anchor of the European Union. Austria, too, managed to emerge from an extraordinarily checkered bankruptcy history by closer integration with post-war Germany, a process that began even before European

integration began to accelerate in the 1980s and 1990s. We shall wait and see which emerging markets can graduate from serial default.